

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Appeals Officer

from: Andrew M. Irving
Senior Counsel, Branch 1
(Income Tax & Accounting)

subject: Casualty Loss Issue

This Chief Counsel Advice responds to your request for assistance dated November 4, 2009. This advice may not be used or cited as precedent.

LEGEND

Taxpayer:

Local Commission:

State:

Successive Storms:

Public Counsel:

year 1:

year 2:

year 3:

x:

y%:

Issue

, a ratemaking body, awarded Taxpayer, utility, a customer representing costs incurred to recover from in year 1.

Does the constitute compensation for the loss, which precludes a casualty loss deduction under § 165 of the Internal Revenue Code, or should the utility take the full amount of the casualty loss deduction in year 1, and treat the as income from providing in successive years when it is collected?

Conclusion

The is an increase to the rate charged by Taxpayer for , not compensation for the losses in year 1.

Facts

Taxpayer is a regulated utility . Taxpayer is regulated by the Local Commission an agency of State.

. In year 1, State was hit by Taxpayer incurred approximately \$ x in damages.

Specifically, Local Commission ruled that Taxpayer did not have to amortize the costs, but could recover the full amount of the costs through a

Taxpayer claimed a casualty loss deduction under § 165 for the year 1 . Because there are some features of this situation that arguably distinguish it from the fact pattern considered in Rev. Rul. 87-117, discussed below, you ask whether the should be treated as compensation or reimbursement for the loss for purposes of § 165 and the corresponding regulations.¹

Law

Section 165(a) allows a deduction for any sustained loss not compensated for “by insurance or otherwise.”

In Boston Elevated Rwy v. Commissioner, 16 T.C. 1084, 1111-1112 (1951), aff’d on another issue, 196 F.2d 923 (1st Cir. 1952), interpreting the phrase “insurance or otherwise,” the Service argued that loss resulting from the abandonment of an elevated railway structure was compensated for by legislation (the Public Control Act) guaranteeing the taxpayer operating profits sufficient to pay dividends. The court disagreed, stating that “regardless of the amounts of any possible losses sustained by petitioner, no payments would be forthcoming to it if its income were sufficiently high, after absorbing the losses and other charges, to pay the required dividends.” Id. at 1112.

In Shanahan v. Commissioner, 63 T.C. 21 (1974), which involved federal disaster relief payments, the Tax Court determined that the general term “or otherwise” must be construed consistently with the specific term “insurance.” The court stated that the general purpose of insurance is to spread the risk of loss from any peril among a large number of those who are exposed to a similar peril.

In Estate of Bryan v. Commissioner, 74 T.C. 725 (1980), the court, citing Shanahan, determined that the phrase “insurance or otherwise” in an analogous provision, § 2054, contemplates that the type of compensation received must be such that it was “structured to replace what was lost.” Id. at 727. The court held that a disbursement from a trust fund established by a state bar association, in compensation for losses incurred due to an attorney’s unethical behavior, was in the nature of insurance.

Rev. Rul. 87-117, 1987-2 C.B. 61, involves a regulated public utility that abandons a partially-completed nuclear plant. The ratemaking authority, in determining to grant the utility a subsequent rate increase, permits the utility to amortize the cost of the plant over a specified number of years and include that amortization in its cost of service for ratemaking purposes. Holding that the rate increase does not reduce the utility’s loss deduction on abandoning the plant, the ruling reasons that although the utility

¹ Other casualty-related issues in the case involve capitalization of post-casualty restoration costs, see , e.g., AM 2006-006, and identification of the “single, identifiable property” damaged or destroyed by the casualties, see, e.g., TAM 200902011. These are independent issues that are not addressed, directly or by implication, in this memorandum.

commission may give consideration to the fact that a utility suffered a loss in determining whether a rate increase is warranted, the rate is not structured to reimburse the utility for its loss. Rather the rate increase is structured to enable the utility to perform its functions of serving its customers at a fair charge, while at the same time maintaining its financial integrity and its ability to attract capital at reasonable terms by paying its investors a reasonable rate of return on their investment. If the taxpayer were not a regulated company, it could raise its price at will, and revenues produced by its price increase could not be considered as compensation for a loss by “insurance or otherwise.” The governmental grant of authority to increase rates is of the same nature as a price increase by an unregulated company. The function of the utility commission is merely to assure that the increase is warranted.

Analysis

Applying this case law and Rev. Rul. 87-117 to the _____ in this case, in some respects the _____ was “structured to replace what was lost” and insurance-like in nature – at least in its effect on Taxpayer

_____. It is also clear that government compensation for casualty damage – whether in the form of a cash grant, debt forgiveness, or a purchase of property for pre-casualty value – is “insurance-like” compensation that reduces or eliminates a loss deduction (and, if it exceeds the basis of property, is eligible for deferral under § 1033).² The right to the _____ arose after the loss occurred, and is contingent on future sales; however, for a payment to be treated as compensation that reduces a loss under § 165, it is not essential that the right to the payment exist at the time of the loss, or even that there be a legal or moral obligation to make the payment. See Estate of Bryan, 74 T.C. at 728, citing Shanahan, 63 T.C. at 23.

On the other hand, here, as in Rev. Rul. 87-117, the utility’s customers are the source of the funds, not the government, whose role is only to set rates for _____. In paying the _____, the customers are not primarily interested in compensating Taxpayer for its losses. From the customers’ point of view, the _____ is simply part of a mandatory payment for _____—deductible under § 162, for a business customer—whether the _____ is separately identified on the customer’s bill or not.³

The _____ is temporary, which is also a common characteristic of insurance. However, this does not distinguish Rev. Rul. 87-117, where the cost of the abandoned plant was amortized over a set time period. Arguably, whether costs are amortized, as

² In addition to Shanahan, see Spak v. Commissioner, 76 T.C. 464 (1981); Rev. Rul. 74-206, 1974-1 C.B. 198; Rev. Rul. 71-160, 1971-1 C.B. 75.

³ Treating the _____ as compensation for the loss would require that Taxpayer exclude a portion of what would normally be ordinary income from operations and, presumably, apply that amount to reduce the basis of assets that were affected by the casualties, a potentially complex task from an administrative standpoint.

in Rev. Rul. 87-117, or recovered directly, as here, is largely a matter of form; in both cases, the taxpayer is arguably "recovering" over a set period the amounts the taxpayer seeks to deduct as a loss.

The _____ was granted _____

_____. Unlike the compensation in Boston Elevated Railway, it was not limited to amounts necessary to achieve a certain level of profit. Nevertheless, as in Rev. Rul. 87-117, the _____ was granted _____ because _____

Finally, as noted in Rev. Rul. 87-117, treatment of the _____ as a reimbursement arguably treats Taxpayer, a regulated business, differently from a similarly-situated unregulated business. Since the basic method for setting a regulated rate is to allow the business to recover its costs plus a reasonable rate of return, arguably all of a regulated business' expenses and capital expenditures are "reimbursed," which would lead to treatment of a regulated business largely as a conduit for tax purposes. However, regulated businesses are not taxed in this way, but generally compute their gross income and offsetting deductions in the same manner as unregulated businesses. If an unregulated business incurs a casualty loss, it must reduce its deduction by any insurance or insurance-like payment, such as a government grant, but the loss deduction is not denied because the business intends to, and does, "recover" the amount of the loss by selling goods or services, and its business income is not treated as an excludible return of capital to the extent of the denied loss deduction. Arguably the result should not differ because a business' rates are set by a government regulator rather than the market.

Taking all these factors into account, we conclude that this situation is not sufficiently distinguishable from the situation in Rev. Rul. 87-117 to call for a different result.

Please call (202) 622-5020 if you have any further questions.

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